Fin Mkts Portfolio Mgmt (2007) 21: 487–489
DOI 10.1007/s11408-007-0064-4

BOOK REVIEW

Jonathan Berk, Peter DeMarzo. Corporate Finance

Pearson International Edition, Addison-Wesley, 2007. 988 pages. Approx. 70 Euro

Rachel Berchtold

Published online: 29 September 2007

In *Corporate Finance*, Jonathan Berk and Peter DeMarzo present corporate finance as the application of a small set of simple core ideas, for example, of absence of arbitrage (or the Law of One Price), and of risk. Each part of the textbook begins by highlighting how the Law of One Price is related to its particular topic.

Corporate Finance's coverage of the major topical areas is aimed at introductory-level and MBA students. The main focus is on financial decision making as it relates to the corporation's choice and funding of investments. The book is divided into 10 parts, comprising 31 chapters. Every chapter includes key terms, notation, historical background, interesting interviews with famous people on topics of recent interest, magazine articles, examples, figures, tables, short summaries of the chapter, suggestions for further reading, problem sets (also in Excel), and data cases. In addition to the textbook itself, students are granted access to the online "MyFinanceLab," which gives them the practice and tutorial help in learning finance. MyFinanceLab includes glossary flashcards and spreadsheets in Excel, as well as online quizzes and tests with solutions. I think the Berk and DeMarzo textbook provides students with a solid grounding in core financial concepts and tools needed to make good decisions. The book is highly pedagogical and mainly addressed to introductory-level students.

Parts I and II lay the foundation for the remainder of the book. In Part I, the authors introduce the corporation and other business forms. They examine how stock markets facilitate trading among investors, the role of the financial manager, and conflicts surrounding ownership and control of corporations. Part I also includes a chapter about basic corporate accounting principles and the financial statements on which financial managers rely. The chapter "Arbitrage and Financial Decision Making" introduces the core ideas on which finance is built, including the Law of One Price, net present

R. Berchtold (✉)
University of St. Gallen, Rosenbergstr. 52, 9000 St. Gallen, Switzerland
e-mail: rachel.berchtold@unisg.ch

value, and risk. These basic ideas are the building blocks on which the rest of the book is built.

Part II presents the basic tools of corporate finance. The time value of money is introduced, methods for estimating the timing of cash flows are described, and the net present value of various types of cash-flow patterns are computed. Other chapters in this part discuss interest rates and investment decision rules, where evaluation alternatives other than net present value are explained.

Part III then applies the valuation principles for discounting cash flows described in Part II to both real and financial assets. The authors explain the basics of valuation for capital projects, bonds and stocks.

Part IV of the book is dedicated to the critical concept of risk and return. The authors' objective is to explain how to measure and compare risks across investment opportunities. The authors introduce mean–variance optimization, derive the capital asset pricing model and examine the strengths and weaknesses of alternative models of risk and return.

Part V illustrates how a firm can raise the funds needed to undertake investments and the firm's resulting capital structure. The role of debt in reducing taxes, the costs of financial distress, and the firm's choice of payout policy are discussed.

In Part VI, the authors return to the topic of valuation and integrate with it the understanding of risk, return and the firm's choice of capital structure. The three main methods for capital budgeting with leverage and market imperfections are developed: the weighted average cost of capital (WACC) method, the adjusted present value (APV) method, and the flow-to-equity (FTE) method. The last chapter of this part, "Valuation and Financial Modeling: A Case Study," presents a capstone case that applies the techniques developed up to this point in the book to build a valuation model for a firm.

Part VII deals with options and the role they play in investing and financing decisions. The commonly used techniques for pricing options, including the Black–Scholes option pricing model and the binomial option pricing model, are introduced. The authors explain the role of real options in capital budgeting.

Part VIII covers the institutional details that are involved in alternative long-term financing sources. Whereas in Part V the financial manager's choice between the major categories of financing, debt, and equity was discussed, this part explains the mechanics of implementing these decisions. At the end of Part VIII, an alternative to long-term debt financing is introduced—leasing. In presenting leasing as a financial alternative, the authors apply the Law of One Price to determine that the benefits of leasing must derive from tax differences, incentive effects, or other market imperfections.

Part IX focuses on short-term financial management. The authors state that in a perfect capital market, the Law of One Price and the Modighliani–Miller propositions imply that how a firm chooses to manage its short-term financial needs will not affect the value of the firm. In reality, of course, short-term financial policy *does* matter due to the existence of market frictions. This part of the book identifies these frictions and the authors explain how firms set their short-term financial policies.

Part X, the last part of the book, is devoted to special topics in corporate financial management. For example, the authors discuss mergers and acquisitions, provide an overview of corporate governance, consider corporations' use of insurance and financial derivatives to manage risk, introduce the issues a firm faces when making a foreign investment, and address the valuation of foreign projects.

Overall, *Corporate Finance* is a good introduction to its topic for undergraduate students. Toward the end of the book, the authors go more into detail and the text becomes more difficult and enriched with derivations. I recommend the book as a reference work for corporate finance classes.